No. 15,299

United States Court of Appeals

For the Ninth Circuit

WALTER J. HEMPY, as Trustee of the Estate of Mechanix, Inc., a corporation, bankrupt,
Appellant,

vs.

JOHN HOWARD SIMS and MARVIN D. MORROW,
Appellees.

APPELLANT'S CLOSING BRIEF.

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APPELLEES' ADDITION TO APPELLANT'S STATEMENT OF FACTS CONTRARY TO EVIDENCE.

Appellees have adopted appellant's statement of facts, but have made certain additions thereto not supported by the record. There is nothing to support the contention that appellees' agreement to remain in bankrupt's service was a present consideration for the preferential payment of their back wages. This will be discussed more fully in replying to the point raised thereon by appellees.

There is also no evidence to support the statement made by appellees that bankrupts had claims in excess of $150,000 for services rendered to the government. This point will be elaborated upon in reply to appellees' argument based thereon.

REPLY TO APPELLEES' ARGUMENT.

In endeavoring to answer our contention that the Court erred in finding that appellees agreed to remain in the employment of the bankrupt, Mechanix, Inc., (T.R. p. 8) appellees rely solely on a purported conflict in the evidence and the rule that the Court of Appeals cannot upset the findings of a trial Court where the evidence is conflicting and where different inferences might be drawn. However, this position is without support, as the Court refused to hear any testimony on this subject, and stated in so many words that it did not regard the question of an agreement to remain employed as an issue. The Court, although it completely shut out this line of testimony from the trial, made a finding on the subject. See T.R. pp. 60-62 inc.

> "Q. (By Mr. Miller.) Mr. Morrow, was it your intention at the time you received this payment on March 8, 1953, to continue in the employ of Mechanix, Inc.?
>
> A. Yes, sir.
>
> (Testimony of Marvin Morrow.)
>
> Mr. Anixter. That is incompetent, irrelevant and immaterial.
>
> A. Yes, sir.
>
> Mr. Miller: I think it is important, your Honor. It could be consideration for the payment as a fact for the Court to consider.
>
> The Court. I would assume that would be the case. Ask another question.
>
> The Witness. I didn't finish my answer.
>
> The Court. Well, I think we have heard enough. I will take it for granted that, whether

it is material or not, you were going to continue on in business if you could.

Mr. Miller. Did you want to ask a question, or did you tell me to?

The Court. I will answer it for him.

The Witness. I want to go a little further.

The Court. Well, you weren't going to leave the business, were you?

A. Yes, I was going to leave the company.

The Court. You were?

A. Yes, sir.

The Court. Then I was wrong.

The Witness. I wanted to explain to the Court why.

The Court. Well, what is the materiality of that? Why did you want to bring that out?

Mr. Miller. I think that would be a question of consideration for the payment, your Honor. That's the point I had in mind.

(Testimony of Marvin Morrow.)

The Court. I think there was already perfectly valid consideration for the payment.

Mr. Miller. No, I say as a matter of law, insofar as this proceeding is concerned, a present consideration should take it out of the preference class.

The Court. How could that be when he has already testified it was back payment that was owing from January, $150.00 as a salary.

Mr. Miller. The point is, he received the payment in order to keep him on the job, which would make it a present consideration.

The Court. I don't think I would go into that. I don't see any merit in that. I don't think a man has to say he is going to stay on the job to get some money that is already owing him.

The Witness. I could explain that.

The Court. You don't need to. I don't think it is necessary. It is only a legal question. If money is owing to you, it is owing to you. A man doesn't have to stand on his head to get something that is already owing him.

Mr. Miller. I have no further questions of this witness."

This appellant having had his objections to this line of questioning sustained, did not pursue the matter any further. Hence, the Court's finding on this subject (T.R. p. 8) was amazing to say the least. Appellant should have had the opportunity to be heard on this point, but certainly could not go into it after appellees themselves were presumably prevented from raising this issue by the Court's ruling above quoted. Consider the ludicrous result of such testimony if it had been considered! The appellees would have been permitted to prove that the two chief stockholders who were also the president and secretary of the bankrupt corporation and who also were directors and between them managed and operated the company would have quit had they not been given preferential treatment over the general creditors of the corporation.

Thus there was not only a considerable lack of conflicting evidence which might support the trial Court's finding, but the District Judge's ruling permitted absolutely no evidence on this subject at all. We respectfully submit that this was not an issue in the case and could support no finding.

Appellees next argue that the Court did not err in finding that appellees did not know nor have reason-

able cause to believe that Mechanix, Inc. was insolvent, and in concluding thereupon that the payments to each of appellees was not preferential.

Appellees first insist that there is ample evidence showing that bankrupt was not insolvent. However, they carefully refrain from referring to any of the tangible proof in the record on this subject, and make only references to vague and self-serving statements, such as the amounts set forth in the bankrupt's schedules, which were prepared by appellees for bankrupt and which were not supported by the bankrupt's records. Plaintiff's Exhibit 1 was the bank balance sheet reflecting those conditions existing at the time the preferential payments were made. It showed a capital deficit of $33,000.00. It indicated a considerably lesser sum due from claims against the Government than was set forth in the schedules. As the managing officers and directors of the bankrupt, appellees were chargeable with knowledge of the company's affairs and financial condition.

Matter of W. A. Silvernail Co., 218 Fed. 978, 33 Am. Br. 59;

Irving Trust Co. v. Roth, D.C. N.Y. 48 F. 2d 345.

Appellees' only basis for avoiding actual knowledge of insolvency rather than even a reasonable cause to believe the bankrupt to be insolvent was a purported belief that they had claims against the Government totaling over $200,000. Although designated as claims the term in this instance was a considerable misnomer and represented a mere hope that the government

would pay the bankrupt for extras supplied in the way of materials and services not contained in the written contract between the bankrupt and the Government. Appellees admitted that their written contracts with the Government provided that authorizations for these extras were required to be obtained in writing from the Government and that the bankrupt had not obtained such authorizations (T.R. p. 69). Thus bankrupt didn't have any actual claims but only hopes. The actual value of these claims or hopes, whichever name is used to designate them, was assessed at the top sum of $23,500 by plaintiff's witness, Peter Hunt, the attorney in charge of collecting these claims, and which was the only testimony on this subject (T.R. p. 84). There can be no doubt from the financial statement (plaintiff's exhibit 1) and the additional testimony referred to in appellant's opening brief that Mechanix Inc. the bankrupt, was hopelessly insolvent at the time the preferential payments were made five days before the petition in bankruptcy was filed against them.

Appellees had reasonable cause to believe that bankrupt was insolvent when they received these payments on their back salaries. Their authorities, with which we do not quarrel, in view of the fact that they are not applicable to the present situation, merely support the contention that mere suspicion is not enough to charge a creditor with knowledge. These cases have no reference to the condition existing in the case at bar where the creditors in question are the managing officers and directors as well as chief stockholders of

the bankrupt corporation. It is also submitted that the trustee met the burden of proof to charge appellees with such knowledge. The appellees, being the operating and managing officers as well as directors and chief stockholders of the bankrupt were presumed to have knowledge of the company's insolvency and its general conditions.

Matter of W. A. Silvernail Co. (supra);
Irving Trust Co. v. Roth (supra);
Cohen v. Tremont Trust Co. (D.C., Mass.), 256 Fed. 399 aff'd 263 F. 81;
New York Credit Men's Ass'n v. Hasenberg, (D.C., N.Y.), 26 F. Supp. 877 aff'd 107 F. 2d 1020;
In re Plant, 148 Fed. 37.

Appellees were also convinced of the truth and the existence of this legal presumption as they made no attempt to refute this argument, which was set forth in appellant's opening brief. As a matter of fact, if the operating and managing officers and directors of a corporation are not presumed to have knowledge of its condition, how could a corporation ever be charged and held responsible for any of its acts. Under these circumstances a creditor who was an officer and director of the corporation could never receive a preference because they would not be required to take cognizance of any facts they acquired in such capacity.

Even the trial Court was convinced that appellees had knowledge of the insolvent condition of the corporation. See oral finding of Court (T.R. p. 91).

> "The Court. I am satisfied they must have felt conditions were getting tight, and they took the money, whether it amounted to a legal status recovery, but with knowledge they were insolvent and with interest to actually prefer themselves."

Yet notwithstanding this oral finding, the trial judge made a contrary finding in writing. Appellees had no comment to make about this situation which was fully disclosed in appellant's opening brief. In fact, how can the trial judge's written and oral findings be reconciled?

The trial Court was convinced by the evidence that appellees received a preference but seemed to justify itself on the basis that officers of a corporation are not to be considered in the same class with other creditors (T.R. p. 93).

> "The Court. Well I will think it over for a day or two. I don't think much of the case Mr. Anixter; most cases of preference are where a creditor comes in and gets the pay in preference against other creditors."

Thus, the trial Court gives its approval to the officers and directors of a corporation who fill their own pockets on the eve of bankruptcy with assets belonging to the general creditors, when these general creditors relied on such officers and directors in dealing with the corporation. This is contrary to the purport of the Bankruptcy Act.

Matter of W. A. Silvernail Co., supra;
Irving Trust Co. v. Roth, supra;
Cohen v. Tremont Trust Co., supra.

Appellees cite the case of *Lang v. First National Bank of Houston,* 215 Fed. 2d 118, because it involves dealings between a contractor and the Government. In no other respect is this case applicable to the situation at bar. The creditor in the *Lang* case was not an officer, director, nor stockholder of the bankrupt corporation and had nothing to do with its management and control. The Court found from the facts that the creditor had no reason to suspect bankruptcy. However, even in this case the Court reaffirmed the rule of law pointed out by appellant in his opening brief to the effect that where facts were raised to cause a person of reasonable prudence to make inquiries he would be charged with the knowledge that could be obtained from such investigation.

McDougal v. Central Union Conference, 2d Cir. 110 Fed. 2d 939;

Collins v. Bank of Titusville and Trust Co., 5th Cir. 36 Fed. 2d 482.

If the managing officers and directors of a corporation performed only their proper functions they would have had knowledge of the corporation's affairs.

For the foregoing reasons the trustee contends that the findings of the trial Court (T.R. pp. 7-9) are unsupported by the evidence adduced and are inconsistent with the Court's own "oral findings" as hereinabove set forth in full.

Therefore, it is respectfully submitted that the judgment of the District Court should be reversed because the payments made by the managing officers and direc-

tors to themselves on account of back salaries at a time when the corporation was insolvent was preferential within the meaning of Section 60(b) of the Bankruptcy Act.

Dated, San Francisco, California,
March 20, 1957.

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